Elements of a Preference
&
Effective Handling of Preference Claims

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BANKRUPTCY PREFERENCE ACTIONS

A. General Overview of Preferences.

One of the underlying policies of the Bankruptcy Code is equality of treatment among creditors. In order to achieve equality, the Code gives the trustee or debtor-in-possession the power to avoid certain preferential transfers made shortly before bankruptcy since these transfers give one creditor an unfair advantage and a larger distribution over other creditors. The ancillary benefit to the trustee's ability to avoid preferential transfers is that creditors are thereby discouraged from racing to levy on the debtor's assets by judicial process on the eve of bankruptcy, and, hopefully, are also discouraged from literally pushing the debtor into bankruptcy.

B. Elements of a Preference.

The Bankruptcy Code defines a preference as:

1. Any transfer of the debtor's property,
2. To or for the benefit of a creditor;
3. For or on account of an antecedent debt owed by the debtor before such transfer was made;
4. Made while the debtor was insolvent;
5. Made
    a. on or within 90 days before the date of the filing of the petition; or
    b. between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
6. That enables such creditor to receive more than such creditor would receive if --
    a. the case were a case under Chapter 7 of the Code;
    b. the transfer had not been made; and
    c. such creditor received payment of such debt to the extent provided by the provisions of this title.

Each element must be proven for the plaintiff (trustee or debtor) to recover a preferential transfer. In essence, a preference is any payment made by an insolvent debtor to an unsecured creditor within ninety days before filing the bankruptcy petition. Even if a bankruptcy trustee or debtor is able to prove all of the elements, a creditor may have defenses to recovery.

C. **Analysis of Elements.**

Although the elements may seem straightforward at first glance, litigation and the resulting court opinions have developed the nuances of each element over the years.

1. **Transfer of Assets.** Note that the word "transfer" is defined in the Bankruptcy Code in the broadest possible terms to include both voluntary (e.g., the granting of a security interest) and involuntary (e.g., the fixing of a judgment lien on real property) transfers.

2. **Time of Transfer.** There has been much litigation regarding the actual time of transfer and how it is calculated. The moment of transfer is critical for computation of the preference analysis. For a time there was a split among circuit courts regarding when the transfer took place for preference purposes when the debtor paid by ordinary (not cashier's) check. Was it when the check was cut . . . when mailed . . . when received by the creditor . . . when it cleared the debtor's account? The U.S. Supreme Court resolved this split by holding that a transfer is considered made for preference purposes on the date that the debtor's check clears the debtor's bank account.

3. **Transfer must have been to or for the benefit of a creditor.** A preference involves favoring one creditor over others. Therefore, only transfers to creditors can be a voidable preference (other transfers to non-creditors may be recoverable as a fraudulent conveyance). "Creditor" is broadly defined under the Code. Guarantors are creditors since they have contingent claims against the debtor (contingent on whether or not the debtor pays the underlying obligation). Transfers that benefit a creditor only "indirectly" may be a preference. For example, when an insolvent debtor makes payment on an obligation to a lender/creditor, and that debt is guaranteed by a third party, the third party receives "benefit" since the third party's liability is decreased.

4. **Transfer for or on account of an antecedent (pre-existing) debt.** Transfers for "new consideration" are not preferences. If, for example, the debtor pays $1,000 and receives $1,000 worth of office supplies contemporaneously, there is no preference because new value (the office supplies) is received in exchange for the payment. The bankruptcy estate has not been diminished by the transaction. In contrast, transfers that pay an old debt or provide security for an old debt may constitute a preference. Therefore, a major part of the preference analysis is determining when the debt was incurred and when the transfer occurred.

5. **Debtor must have been insolvent at time of transfer.** Since the purpose of preference law is to recover transfers made to creditors who were

"preferred" to the detriment of other creditors, the insolvency analysis is critical. If the debtor was solvent at the time the transfer occurred — and therefore had sufficient assets to pay all of its debts in full — then there can be no "preference" of one creditor to the detriment of another.

The Bankruptcy Code creates a "presumption of insolvency" whereby it is presumed that the debtor was insolvent on and during the ninety days immediately preceding the date the bankruptcy petition was filed. This eliminates the need for the trustee to provide evidence of insolvency. If the creditor is able to provide evidence of the debtor's solvency, however, the burden of proof shifts to the trustee who must show that the debtor was insolvent during the ninety day period when the transfer occurred.

6. **The transfer must have been made within the 90-day/365-day preference period.** The normal preference period is ninety days. However, if the transfer is made "to or for the benefit of" an "insider" then the preference period is one year. The Bankruptcy Code has a specific definition of "insider" dependent upon whether the debtor is an individual, a corporation, a partnership or other entity, but generally speaking, an insider is a relative or person with substantial control over the debtor. The rationale for the one year preference period is that an insider is in a unique position and often able to control to whom payments are made. Therefore, an insider who sees bankruptcy looming on the horizon can make sure that the debtor's obligations to him or her are paid first. The insider's unique knowledge subjects him to a full one year preference period. Otherwise, the insider would cause the preferential payment to be made and then would simply delay the bankruptcy filing for ninety days. A one year delay is much more difficult and when creditors learn of transfers to insiders, the one-year period provides an adequate period of time to determine whether to file an involuntary petition against the debtor so that the insider's preference can be recovered.

7. **Transfer must enable creditor to receive more than creditor would have received in liquidation.** The amount each creditor would receive under a Chapter 7 liquidation is reasonably easy to calculate — valuation issues notwithstanding. If a creditor would receive the same amount in a liquidation case by virtue of his distribution priority, then there can have been no preference. This section comes into play most often when a fully secured creditor has received a payment during the preference period. If the obligation was fully secured (and could not be avoided by a trustee) then the payment theoretically has freed up an equal amount of value in the debtor's assets which serve as the collateral. It is therefore impossible for a properly perfected fully secured creditor to receive a preferential payment since, upon liquidation, the collateral would be liquidated and the creditor paid from the proceeds. The actual value of the collateral may be an important topic of litigation since undervalued collateral could leave the creditor exposed to a preference recovery.

D. **Preference Defenses.**

1. **Contemporaneous Exchange for New Value Defense.** 11 U.S.C. § 547(c)(1). A transfer of the debtor's property to a creditor does not result in a preference if it was, in fact, a "substantially contemporaneous exchange" for new value. For example, if the debtor purchases new inventory and at the time of the purchase, gives the seller a check (backed by sufficient funds) in payment of the price, there is no preference because the check is not on account of an antecedent debt, but rather is in exchange for new value. The Code defines new value as "money or money's worth in goods, services or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void or voidable by the debtor or the trustee under any applicable law, but does not include an obligation substituted for an existing obligation."

   The new value need not necessarily be provided by the debtor. For instance, when the debtor transfers assets to a transferee that was the beneficiary of a letter of credit and in exchange the issuing bank releases collateral of the debtor securing the letter of credit, the conditions for the new value exception are satisfied. In a case where the debtor purchases inventory and, at the time of sale, gives the seller a personal check for payment of the price but the seller waits three weeks to deposit the check (and deposits it within the preference period) does payment of the check constitute avoidable preference? Although payment by personal check is often is viewed as a credit transaction, such payment is "intended to be contemporaneous" and is treated as a cash transaction for preference purposes. The Code considers payment to be made when the check is delivered, unless it is dishonored. As noted above, however, when a check is received by a creditor to pay a pre-existing debt, the transfer is considered made when the debtor's bank honors the check.

2. **Ordinary Course of Business Defense.** 11 U.S.C. § 547(c)(2). The whole concept of preference recoveries is to prevent payments which are outside of the normal business dealings of the debtor - that is, to prevent some creditors from being preferred over others. The Code does not wish to disturb normal business transactions that occur between the debtor and a creditor, even up to the actual moment of the bankruptcy filing. In fact, creditors who continue to deal with the troubled debtor and who receive payments in the "ordinary course" are exempt from preference recovery. There are two requirements to satisfy the Code's "ordinary course" defense:

   a. <u>The transfer was in payment of a debt that was incurred in the ordinary course of business</u> or financial affairs of the debtor and the transferee (financial affairs refers to the non-business activities of a consumer debtor...such as the payment of monthly utility bills), and either:

(i) <u>Payment was made in the ordinary course of business or financial affairs of the debtor and the transferee (subjective test)</u>. This factor requires that the court resolve the issue of "ordinariness" by reference to the similarity or deviance of the questioned transaction compared to prior transactions between the debtor and the preferred creditor. For example, if historical transactions between the parties have resulted in payment being made on an average of the twenty-ninth day after the invoice was sent and the questioned payment was made on the forty-fifth day, then arguably the payment is outside the ordinary course dealings between the parties; **or**

(ii) <u>The payment was made according to ordinary business terms for the applicable industry (objective test)</u>. Certain courts interpret this as referring to the practices and customs common to the industry or business in which the debtor and the transferee are engaged. Creditors can have a difficult time proving what is "ordinary" in a particular industry, and often must resort to an expert witness to establish this defense. However, if the preferential transfer was not ordinary as between the debtor and creditor, this objective defense may be critical to avoiding liability.

3. **Enabling Loan Defense.** 11 U.S.C. § 547(c)(3). This exception shelters from avoidance transfers of a security interest in property of the debtor to a creditor when that creditor's loan enabled the debtor to acquire the property. To come within the scope of the exception, the creditor must show:

a. That the security interest secures new value;

b. That it was given at or after the signing of the security agreement describing the collateral;

c. That it was given for the purpose of enabling the debtor to acquire the property and that the value was, in fact, used for that purpose; and

d. That the security interest is perfected on or before thirty days after the debtor receives possession of the property.

This protection applies only to security interests given in connection with new extensions of credit. In essence, the exception protects sellers and lenders who extend credit to enable a debtor to purchase the property that becomes the collateral for the extension of credit.

4. **Subsequent Extension of New Value Defense.** 11 U.S.C. § 547(c)(4). In certain situations, the relationship between the debtor and the creditor will be marked by a series of payments and advances made during the preference period. Since the goal of preference actions is to avoid only the net diminution to the bankruptcy estate, this defense functions to reduce the size of an otherwise avoidable preference by the amount of "new value" that the preferred creditor can prove was extended to the debtor after receipt of the challenged payment and before the petition was filed. Some courts hold that a subsequent advance may be netted only against the immediately preceding preference, but most courts have rejected that interpretation in favor of the more lenient interpretation that, when a creditor's advance of new value exceeds the amount of the immediately preceding preferential payment, the excess may be credited against earlier preferential transfers, if any, until exhausted.

To be eligible, the new value must be unsecured. While new value does not have to be a cash advance, the case law is clear that any non-cash consideration must have a strong showing of "material benefit" to the debtor.

a. Majority View. Under this method, subsequent advances of new value may be used to offset prior (although not immediately prior) preferences. A creditor is permitted to carry forward preferences until they are exhausted by subsequent advances of new value.

The rationale behind this method is two-fold. First, it encourages creditors to do business with financially troubled debtors. A creditor will be more likely to continue to advance new value to a debtor if all these subsequent advances may be used to offset a prior preference. If a second advance of new value carries no benefit, the creditor will be unlikely to make it. *See, e.g.*, *In re Meredith Manor, Inc.,* 902 F.2d 257, 259 (4th Cir. 1990). Second, this approach recognizes the fluid nature of ongoing commercial activity where a creditor looks to a debtor's entire repayment history, instead of one isolated transaction, to decide whether to advance new credit.

b. Transactional Approach. Under this approach, the new value given by the creditor may be used to offset only the immediately preceding preference.

5. **Floating Liens in Inventory and Receivables Defense**. 11 U.S.C. § 547(c)(5). This exception protects transfers that create a perfected security interest in inventory and receivables, or the proceeds of either. It is designed to protect the creditor whose lien is designed to "float" over a constantly shifting body of collateral. However, the exception is qualified by an "exception to the exception," which says that to the extent the secured creditor's position is improved over the course of the preference period, a preference exists. This is commonly referred to as

"improvement in position" test. This test requires measuring and comparing both the amount of the creditor's debt and the value of the collateral, including proceeds, at two points in time:

a. Ninety days before the bankruptcy was filed; and

b. The date the bankruptcy is filed.

To the extent this analysis shows a decrease in the undersecured creditor's unsecured deficiency (or the creation of a surplus) between the two dates, an avoidable preference has occurred and the lender's secured claim will be reduced accordingly. It makes no difference whether the improvement in position was due to an increase in the value of the collateral or a decrease in the amount owed or a combination of both. Otherwise, even though the debtor's inventory may have turned over during the ninety days prior to the filing, the lender retains it's entire lien in the bankruptcy case.

Consider, for example, the following:

(1) A preexisting inventory loan with a balance owed at all times of $200,000;

(2) Level of inventory ninety days prior to filing was $100,000;

(3) At time of bankruptcy petition, inventory value is $150,000;

(4) Result: Trustee may avoid the $50,000 improvement of position; creditor is left with a $100,000 secured claim and $50,000 unsecured claim.

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Lisa practices in the areas of Bankruptcy and Commercial Litigation, and she is the Chair of our Bankruptcy and Creditors' Rights practice group. She is licensed and has practiced in the federal and state courts in North Carolina, South Carolina, and Virginia.

Representative Experience

- Represent secured and unsecured creditors, including creditors' committees, in bankruptcy court on contested matters such as cash collateral, DIP financing, claims objection and lien contests, stay relief, confirmation, and executory contracts
- Represent creditors and debtors in out-of-court workouts and forbearance agreements
- Represent bidders and purchasers of assets from a bankruptcy estate as well as debtors or trustees selling assets in bankruptcy
- Represent creditors in defense of preference actions as well as debtors, trustees or committees in prosecution of avoidance actions
- Represent banks and other business interests as plaintiff and defendant in commercial litigation including lender liability, lease disputes, and disputes arising from small business break-ups

Representative Unsecured Creditors' Committee Cases

- NC Power Holdings, LLC (Chapter 11, EDNC)
- Den-Mark Homes SC, Inc. (Chapter 11, EDNC)
- South Brunswick Water and Sewer Authority (Chapter 9, EDNC)
- E-Z Serve Convenience Stores (Chapter 11, MDNC)
- Unit Dose Solutions (Chapter 11, MDNC)
- Augusta Tissue Mill (Chapter 11, MDNC)
- New Course Education, Inc. (Chapter 11, MDNC)
- Burruss Company (Chapter 11, WDVA)

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Creditors' Rights & Bankruptcy

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North Carolina Bar Association, Bankruptcy Section, Former Chair of Seminars Committee

Carolinas Chapter of Turnaround Management Association, Board of Directors

American Bar Association, Business Law Section, Committee on Business Bankruptcy, Vice Chair of Subcommittee on Legislation

American Bankruptcy Institute

Recent Publications

Did You Know? Bankruptcy and Collection Tips, Whose Business is Ordinary?

North Carolina's Identity Theft Law Reaches Far Beyond State Borders

Notable Accomplishments

Ranked in *Business North Carolina* magazine's "Legal Elite" (Bankruptcy), 2010

Ranked among *Law & Politics* magazine's North Carolina "Rising Stars" (Bankruptcy & Creditor/Debtor Rights), 2009

Recognized as a Triangle "Mover & Shaker" by Business Leader Media, 2009

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Jill joined the firm in September of 2008 and is a member of the Creditors' Rights and Bankruptcy Section. She regularly represents creditors in United States Bankruptcy Court and out-of-court workouts. Jill also represents lienholders and suppliers involved in construction disputes and a variety of state court litigation matters.

Prior Legal Experience

Jill spent her first year of practice as a Staff Attorney for the United States Bankruptcy Administrator for the Eastern District of North Carolina.

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Wake County Bar Association, Young Lawyers' Division

Carolinas Network of the International Women's Insolvency and Restructuring Confederation (IWIRC)

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Priming Liens in Bankruptcy: "Don't Throw Me Under the Bus!"

Little Errors = Big Losses with Deeds of Trust

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